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...e Court of the United States.

OCTOBER TERM, 193...

No. 31.

...RELVERING, COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

UNION PACIFIC RAILROAD COMPANY,

Respondent.

...ER TO PETITION FOR WRIT OF CERTIORARI.

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OCTOBER TERM 1934.

No. 51.

GUY T. HELVERING, Commissioner of Internal Revenue,
Petitioner,

vs.

UNION PACIFIC RAILROAD COMPANY.

ANSWER TO PETITION FOR WRIT OF CERTIORARI.

UNION PACIFIC RAILROAD COMPANY, respondent in the above entitled proceeding, submits the following answer to the Commissioner's petition for a writ of certiorari to the United States Circuit Court of Appeals for the Second Circuit on the question of the allowance of amortization of commissions incurred on bond issues prior to 1913.

1.

THE POINT AGAINST AMORTIZATION OF PRIOR-TO-1913 BOND COMMISSIONS IS MERELY AN ATTEMPT TO SALVAGE SOMETHING OUT OF THE COMMISSIONER'S DEFEAT IN A LONG STANDING CONTROVERSY WITH CORPORATE TAXPAYERS IN WHICH THE RIGHT TO AMORTIZATION OF BOND DISCOUNT, WHENEVER INCURRED, WAS ESTABLISHED. THE POINT IS WITHOUT MERIT.

A narrative of a prolonged controversy is necessary to the Court's understanding, in proper perspective, of the question presented by the Commissioner's certiorari application.

Amortization of discount, commissions and expenses on bond issues always recognized if incurred after March 1, 1913.

From the beginning of its administration of the income tax laws the Bureau of Internal Revenue in its official regulations recognized the right to deduct annual amortization of discount incurred on the issue of corporate bonds and in fact required amortization (Article 135 of *Regulations 33,* governing the administration of the 1913 law). The same regulations as revised to govern the administration of the 1916 law expressly included in such annual amortization the commissions and incidental expenses incurred in connection with bond issues (Article 150 of *Regulations 33 revised*). Subsequent regulations governing the later income tax laws have all required the annual amortization of discount. While the subsequent regulations have not contained express mention of commissions and incidental expenses, it has at all times continued to be the practice of the Bureau to amortize commissions and incidental expenses as well as discount (see administrative rulings cited on page 6 of the petition).

Bureau made exception, however, against amortization of prior-to-1909 bond discount.

The general rule above stated was however subject to an exception to the effect that such amortization would not be allowed in case the bonds had been sold prior to 1909 and the discount charged to income or profit and loss in the year of issue (*Treasury Decision* 2161, dated February 19, 1915, and Article 149 of *Regu-*

lations 33 revised). This exception was based on the theory that the charging off of the entire discount in some year prior to the incidence of the Corporation Excise Tax Act of 1909, being the first income tax law, constituted a conclusive election to treat the discount as a closed transaction. This theory was directly contrary to the elementary rule that income tax liability is not to be determined by bookkeeping.

Board and Courts overruled exception and recognized amortization of bond discount whenever incurred.

The above stated position of the Bureau was at first sustained by the Board of Tax Appeals in *Western Maryland Railway Co.*, 12 B. T. A. 889, 907. That decision was, however, shortly thereafter reversed by the Board itself in *Chicago, Rock Island & Pacific Railway Co.*, 13 B. T. A. 988, 1027-1034, which held that the amortization of discount must be recognized equally whether the bonds were sold prior to the incidence of the income tax laws or thereafter and regardless of the taxpayer's method of accounting for the discount. The Commissioner did not appeal. The decision to the contrary in the *Western Maryland* case was reversed by the Circuit Court of Appeals for the Fourth Circuit in 33 Fed. (2d) 695, 696, and the Commissioner did not seek certiorari.

The Board has consistently followed its decision in the *Rock Island* case as to discount amortization (*Kansas City Southern Ry. Co.*, 16 B. T. A. 665, 686; *St. Louis Terminal Railroad Association*, 17 B. T. A. 1135, 1169; *Chicago & North Western Railway Co.*, 22 B. T. A. 1407, 1435).

Exception made in Rock Island case against amortization of incidental expenses of prior-to-1913 bond issues.

The *Rock Island* case, *supra,* involving the question of prior-to-1909 discount, also involved among numerous other questions the question of amortization of incidental expenses of several bond issues the last of which had been sold in 1908. The Bureau, consistently with its position as to the bond discount, denied the right to such amortization and in the interest of a more complete consistency advanced an affirmative claim that its allowance previously made to the Rock Island of amortization of incidental expenses of certain bond issues sold in 1917 and 1919 was erroneous, 13 B. T. A. 1034-1035. The Board held that the amortization of the expenses of the *later* bond issues was proper, since such expenses constituted a part of the cost of the borrowed money. But it held that the expenses incidental to the *earlier* bond issues were not entitled to amortization, on the ground that: "since the "Circuit Court of Appeals has held in the *Old Colony "Railroad Co.* case, *supra,* (referring to *Commissioner* v. *"Old Colony Railroad Co.,* 26 Fed. (2d) 408) that "premiums actually received prior to March 1, 1913, are "not taxable income, by the same token, expenses actually "paid prior to said date are not deductible from gross "income of taxable years".

This decision as to prior-to-1913 expenses was affirmed by the Circuit Court of Appeals for the Seventh Circuit in 47 Fed. (2d) 990, 991. The taxpayer petitioned for a writ of certiorari which was denied by this Court, 284 U. S. 618.

Thereupon the Bureau naturally sought to differentiate commissions from discount and disallow amortization of prior-to-1913 commissions as analogous to incidental expenses.

When the Bureau was defeated, as above shown, as to prior-to-1909 discount but was sustained as to prior-to-1913 incidental expenses there were pending some other railroad cases involving the question of amortization of prior-to-1909 bond discount. In an endeavor to salvage as much as possible out of the defeat on the discount question, the Bureau asserted in these cases a distinction between strict discount and commissions to bankers and underwriters and took the position that such commissions were ruled by that part of the decision in the *Rock Island* case, *supra,* against the amortization of prior-to-1913 expenses rather than by that part of the same decision in favor of the amortization of prior-to-1909 bond discount. The first case to come before the Board on this issue was that of the *Kansas City Southern Railway Co.,* 22 B. T. A. 949, 966. The Board decided without discussion that the amortization of prior-to-1913 commissions was not allowable, citing its decision as to the amortization of prior-to-1913 expenses in the *Rock Island* case. When the Union Pacific Railroad Company's cases, out of which the present certiorari application grows, came before the Board the Commissioner contested the allowance of commissions incurred prior to 1913, although conceding that the right to deduct amortization of discount, whenever incurred, was established (Board opinion, Transcript, pp. 52-53). The Board disallowed the amortization of such commis-

sions on the authority of its decisions against amortization of prior-to-1913 expenses in the *Rock Island* case, *supra,* and against the amortization of prior-to-1913 commissions in the *Kansas City Southern* case, *supra.* The Circuit Court of Appeals for the Second Circuit has reversed the Board on this point (Tr. pp. 101-103). It is this action which the Commissioner seeks certiorari to review.

The decision below sustaining the amortization of prior-to-1913 commissions is obviously sound.

The opinion of the court below, reversing on the commission amortization point the decision of the Board, is an able presentation in support of its conclusion. The opinion says (Tr. p. 101) that petitioner "argues with persuasive force that commissions should be dealt with on the same basis as discount." In other words, the court agreed with our contention that there is a complete analogy between discount and commissions and that the decisions establishing the right to amortization of prior-to-1909 discount should be taken as establishing the right to the amortization also of prior-to-1913 commissions. However, the opinion did not rely wholly upon this reasoning, and the allowance of the amortization may be sustained upon other grounds.

The principle controlling the decision of the point in question is so simple and elementary, whether the application is to discount or commissions or incidental expenses, that this general controversy ought not to have been so greatly prolonged. The persistence of the Bureau

in developing from the main controversy separate questions as to amortization of incidental expenses and amortization of commissions after the correct principle was discovered and applied to the discount question in the *Rock Island* case, 13 B. T. A. 988, 1027, has been unjustifiable.

The specification of allowable deductions in Section 234(a) of each of the income tax laws of 1918 and 1921, taken as a whole, evidences a broad policy to allow the corporation to deduct under one name or another the entire cost of conducting its business. Separate paragraphs authorized the deduction of ordinary and necessary expenses, of interest, of depreciation and exhaustion, of losses and other items of cost not here material. Any item of cost of doing business which is properly applicable to the tax year is chargeable against the income of that year, regardless of when it was paid. If a payment is made in advance which is clearly applicable to future years, or if a liability is incurred which is applicable to years prior to its maturity, amortization is essential in order to reflect correctly the income of the several tax years. This principle is and always has been fully recognized by the Bureau with the exception only of the confusion in which it became involved as to amortization of items growing out of bond issues made prior to 1913.*

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* Note: A current ruling on amortization is found in General Counsel's Memorandum 13148 published in the Internal Revenue Bulletin dated June 18, 1934 (Volume XIII, No. 25, page 2) which is so enlightening upon the general practice of the Bureau not merely to recognize but to require amortization as to a wide variety of expenditures that we print it in full in an appendix hereto.

Under the principle last stated it is immaterial that the advance payment was made or the liability incurred prior to March 1, 1913. Any portion of the payment or liability properly apportionable to tax years subsequent to March 1, 1913, is a cost of doing business in those years and does not represent an expense *incurred for years prior to 1913.*

So, in the present case, if the commissions on the bond issues made prior to 1913 be considered as deducted, like the discount, from the amount of the loan at the time of the bond issue, then no disbursement prior to 1913 is involved, but a liability was created to be met at the maturity of the bonds, which liability represents a cost incurred in securing the loan and which should, in anticipation of maturity, be prorated annually over the life of the loan. This is the view which the Court below preferred (Tr. pp. 102-103). But, if on the other hand the commissions be considered as disbursements made at the time of the bond issue, they nevertheless represented an advance payment of the cost of the loan and of the use of the borrowed capital which should be amortized over the life of the loan, and the amount apportionable to the tax years represented a cost of doing business in those years and not an expense of the year in which the bonds were issued. In neither view of the matter does the fact that the transaction originated prior to 1913 have any significance.

Commissions on bond issues bear a close analogy to improvements made by a lessee upon leased property which will revert to the lessor at the end of the term. The amortization of the cost of such improvements is allowed. See *Kunkel & Co.,* 3 B. T. A. 133, 138-9, and *Strand*

Amusement Co., 3 B. T. A. 770, 776. In Solicitors Recommendation 2499 (Cumulative Bulletin, Vol. IV-1, p. 142), such amortization was recognized and without a suggestion that the right was in any wise affected by the fact that the improvements there considered were made prior to 1913.

2.

THERE IS NO CONFLICT OF DECISIONS.

The petition advances as a reason for granting the writ that the decision of the Circuit Court of Appeals for the Second Circuit in this *Union Pacific R. R. Co.* case is in conflict with the decision of the Circuit Court of Appeals for the Seventh Circuit in the *Rock Island* case, 47 Fed. (2d) 990, to which we have already referred.

The assertion of a conflict is necessarily based on the premise that the *commissions* to bankers and underwriters in connection with the bond issues involved in this *Union Pacific* case and the *incidental expenses* of bond issues involved in the *Rock Island* case are equivalent subject matters. The premise is unsound.

In this *Union Pacific* case commissions on three bond issues were involved. In the case of Union Pacific Railroad Company's convertible bonds sold in 1907 commissions amounting to $134,176 were allowed to bankers for their services as syndicate managers. In the case of Union Pacific Railroad Company's first lien and refunding bonds sold in 1908 commissions amounting to over $1,214,000 were allowed to bankers as their compensation for selling the bonds to the public. In the case of Oregon Short Line Railroad Company's refunding bonds sold in 1904

commissions amounting to $960,000 were allowed in part to an underwriting syndicate and in part to bankers for forming and managing the syndicate. The commissions ranged from the rate of ½ of one per cent to 2½ per cent. The facts were fully pleaded in the amended petition to the Board (Tr. pp. 19 to 25) and admitted by answer (Tr. p. 28).

The character of the incidental expenses of bond issues which were the subject matter of the expense amortization point in the *Rock Island* litigation was not shown. The findings of fact show merely schedules of various bond issues, giving the amounts issued and with a column headed "Expense (charged to profit and loss on date of sale)" in which the amounts claimed were entered. (See findings in *Rock Island* case, 13 B. T. A. 988, at p. 1010.) It is a fair inference that these expenses were the incidental expenses of bond issues such as printing, engraving, stock exchange fees, etc., and did not include commissions to underwriters or bankers. The amounts claimed in the expense column do not constitute one-half of one per cent. of the aggregate of the bonds issued and, therefore, commissions were clearly not involved.

The decision of the Circuit Court of Appeals for the Seventh Circuit in the *Rock Island* case, 47 Fed. (2nd) 990, cited as conflicting with the decision below and dealing with expenses of an undescribed character, might well have been different had bankers and underwriters commissions constituted the subject-matter. In that case that court might have reached the same conclusion as the court below in this *Union Pacific* case, based on the inherent analogy between such commissions and strict discount, both of which are in their nature capital items.

Further, the determination as to what expenditures in any transaction deserve amortization necessarily involves the exercise of some discretion concerning the facts and does not present exclusively a question of law. That is to say, certain items of expense may be too trivial in amount or of too unimportant a character to deserve the dignity of amortization over a long period, and this may be so even though they constitute, together with other classes of items, a substantial aggregate. Therefore, it cannot be said as a matter of law that there is error in a decision denying amortization to a claim for expenses aggregating less than one-half of one per cent of the face amount of a bond issue and unaccompanied by any specification or description of the items making up the aggregate claim. This Court's denial of certiorari in the *Rock Island* case, 284 U. S. 618, may well have been upon the consideration last mentioned and in any event is not entitled to be regarded as an affirmance on the merits.

The reasoning of the Board of Tax Appeals and the Circuit Court of Appeals for the Seventh Circuit in the *Rock Island* case that the decisions* in the *Old Colony* litigation* against the amortization of prior-to-1913 bond *premiums* control the question of the deduction of amortization of prior-to-1913 *expenses* was clearly erroneous. There is no constitutional problem concerning *deductions* from income. Deductions are a mere matter of statute

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*(*Old Colony Railroad Co.*, 6 B. T. A. 1025; affirmed in *Commissioner* v. *Old Colony Railroad Co.*, 26 Fed. (2nd) 408; certiorari granted but dismissed on motion of petitioner, 279 U. S. 876. Second litigation: *Old Colony Railroad Co.*, 18 B. T. A. 267, 275; reversed in *Commissioner* v. *Old Colony Railroad Co.*, 50 Fed. (2nd) 896; reversed in 284 U. S. 552).

and as to them Congress is not controlled by any constitutional restriction. An undue burden would be imposed on this respondent by the granting of the Commissioner's application for certiorari in the present case simply to the end that this Court have an opportunity to express its disapproval of the unsound reasoning on which the Circuit Court of Appeals for the Seventh Circuit based its decision in the *Rock Island case*. A denial of this application for certiorari would evidence the judgment of this Court that the two decisions are not conflicting. It would leave the decision in the *Rock Island* case to stand as denying, in the case of prior-to-1913 bond issues, the amortization of incidental expenses of a miscellaneous character. It would not foreclose the assertion by any litigant of a claim that some particular expenses of a bond issue were of such amount and importance as to deserve amortization equally with commissions under the decision in this case. No serious injustice would be occasioned, considering the less important amounts involved in the miscellaneous incidental expenses of bond issues relatively to the amounts of commissions.

Conclusion.

The petition should be denied.

June 29, 1934.

Respectfully submitted,

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Appendix.

INTERNAL REVENUE BULLETIN.

June 18, 1934. Vol. XIII, No. 25.

General Counsel's Memorandum 13148.

REVENUE ACTS OF 1918, 1921, 1924, 1926, 1928, and 1932.

Where insurance premiums are deductible as business expenses and are paid in advance for a period of more than one year, only the pro rata part of such payment is allowable as a deduction each year, regardless of whether the income is reported on the cash receipts and disbursements basis or on the accrual basis.

Advice is requested relative to the proper treatment, for Federal income tax purposes, of insurance premiums paid in advance by a taxpayer who renders returns on the basis of cash receipts and disbursements, where such premiums are deductible as business expenses.

Section 41 of the Revenue Act of 1932 provides in part as follows:

> The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. * * *

Similar provisions are contained in the Revenue Acts of 1918 to 1928, inclusive.

In *Appeal of J. Alland & Bro., Inc.* (1 B. T. A., 631), the Board of Tax Appeals held that a taxpayer keeping its books of account upon the cash receipts and disbursements basis for 1921 is not entitled, under the provisions of section 234(a)1 of the Revenue Act of 1921, to deduct in its income tax return for 1921 any part of a bonus or advance rental paid by it under an agreement of lease upon premises which it was to occupy on and after January 1, 1922. In the course of its opinion, the Board commented as follows:

> * * * The tax is an annual tax. The theory of the law is that the true gains of each year shall be subjected to the tax. Where, therefore, a taxpayer claims that it is entitled to deduct from gross income an amount which is not clearly an expense item properly chargeable against the gross income of the particular year, it is incumbent upon the taxpayer to show that it is at least within the letter of the provision of the law permitting the deduction.

(See also *J. Alland & Bro., Inc.* v. *United States,* 28 Fed. (2d), 792).

Commissions paid for the purpose of securing long-term leases have been consistently held to constitute capital expenditures deductible ratably over the term of the lease even though the taxpayer's accounts are kept on the cash basis. (*E. N. Webb* v. *Commissioner,* 20 B. T. A., 274; *Mary C. Young* v. *Commissioner,* 20 B. T. A., 692; *Evalena M. Howard* v. *Commissioner,* 19 B. T. A., 865; *S. M. Clawson* v. *Commissioner,* 19 B. T. A., 1253.)

In *Julia Stow Lovejoy* v. *Commissioner* (18 B. T. A., 1179), the taxpayer, whose returns were rendered on the cash basis, paid fees, commissions, and printing costs in securing a loan over a period of years. In disallowing the amounts so paid as a deduction in the year of payment, the Board said:

> In its essence such a disbursement is not unlike bond discount, prepaid rent, cost of acquiring or disposing of a leasehold or term contract and many other transactions. They should be spread over the definite period of the loan, lease, or contract. (*Chicago, Rock Island & Pacific Railway Co.*, 13 B. T. A., 988; *J. Alland & Bro., Inc.*, 1 B. T. A., 631; *Alland* v. *United States*, 28 Fed. (2d) 792; *United States Playing Card Co.*, 15 B. T. A., 975; *Bonwit Teller & Co.*, 17 B. T. A., 1019.) This is on the theory that they result in property of a sort and its cost is being exhausted proportionately over a period of years and should be provided for on the basis of time, production, or otherwise. (Section 214(a)8.)

In *Higginbotham-Bailey-Logan Co.* v. *Commissioner* (8 B. T. A., 566), where the petitioner's accounts were kept on the accrual basis, the Board approved the Commissioner's adjustment of interest and insurance payments on the basis of prorating such payments over the period for which made. The Board stated in part that—

> * * * The payment in advance of premiums for insurance results in the creation of an asset, since the policy has a surrender value. The asset value is exhausted ratably over the term for which the premium is paid. In the balance sheet such items are often carried as assets under such terms as prepaid insurance, or prepaid expense. * * *

The payment in advance of insurance premiums by a taxpayer rendering returns on the cash receipts and disbursements basis likewise results in the creation of an asset. In order to reflect clearly the income of such taxpayer, only the amount applicable to carrying such insurance for the taxable year constitutes an ordinary and necessary expense in the earning of the income for that year.

It is, therefore, the opinion of this office that where insurance premiums are deductible as business expenses and are paid in advance for a period of more than one year, only the pro rata part of such payment should be allowed as a deduction each year, regardless of whether the income is reported on the cash receipts and disbursements basis or the accrual basis.

ROBERT H. JACKSON,
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